ST 06-0007-PLR 06/12/2006 SERVICE OCCUPATION TAX

The purchase of a conveyor system does not qualify as a purchase of special order machinery because the conveyor system cannot be shown to have use or value only to the purchaser. See 86 Ill. Adm. Code 130.2115. (This is a PLR.)

June 12, 2006

Dear Xxxxx:

This letter is in response to your firm's letters dated March 25, 2004 and March 1, 2006. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.ILTAX.com to review regulations, letter rulings and other types of information relevant to your inquiry.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to ABC for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither ABC nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

March 26, 2004 letter:

I am writing to you requesting a Private Letter Ruling (PLR), pursuant to 2 Ill. Admin. Code Sec. 1200.110, addressing the sales and use taxability of a specially-designed automated storage and retrieval system (the conveyor) which our client has purchased. PLRs respond to inquiries made by taxpayers or their representatives under power of attorney (attached). Further, we understand that PLRs discuss tax principles or applications and are binding on the Illinois Department of Revenue (the IDOR) to the extent that the material facts of the situation remain the same, and the law relied upon in the ruling does not change.

FACTS

ABC is a distributor of multiple lines of beverage products (Product). To streamline its inventory operations and achieve cost efficiencies, ABC contracted with a business (the Seller) to design, engineer, fabricate, and install a large-scale, specially-designed, and automated conveyor for use at its Illinois distribution facility (the Warehouse). ABC uses the conveyor to account for, hold, and release inventory. The conveyor fulfills customers' orders by retrieving inventory and packaging Product for delivery. The conveyor is operated entirely through a computer system, which the Seller has customized for ABC. ABC, in considering design requirements, also required a conveyor system engineered to conform specifically to the particular size, shape, and layout of the Warehouse and the Products.

To meet all of the aforementioned requirements, ABC selected the Seller over other businesses because of the Seller's unique specialization in engineering, designing, fabricating, and installing warehouse distribution equipment for businesses in ABC's industry. The Seller's website emphasizes its 'custom approach to case picking and sorting systems' and its dedication to a design methodology which 'grows with [its customers'] needs.' Moreover, with regard to product service, the Seller highlights its focus on providing customers with systems 'specially designed to meet their needs.'

The conveyor was erected in the form of towers, which consist of cells specifically designed to handle the sizeable number of stock-keeping units (SKUs or numbers associated with product for inventory purposes) required by ABC. The Seller configured two types of cells, one for Products not exceeding eight inches in height and another for Products exceeding eight inches in height and sixteen inches in length. In designing and fabricating the cells, the Seller was required to perform several testing simulations to account for the Products' fragile nature. The simulations helped to ascertain the system's most efficient placement of cells. The simulations were completed by using ABC's Product and flow data to determine the most efficient inclines and speeds with which the Product should be delivered to the palletizing station. The tests were conducted by experimenting with differing conveyor speeds in conjunction with varying inclines, weights, shapes, and sizes—while focusing on maintaining minimal Product breakage. The results of these tests allowed the Seller to design the conveyor system according to the precise specifications and needs of ABC.

The Seller's *Sales Agreement* (a portion of which is attached herein as Exhibit A) and approximately 40 blueprints (a portion of which is attached herein as Exhibit B) evidence the Seller's substantial contribution to the detailed design of the conveyor. The *Sales Agreement* allows for ongoing design changes in order to accommodate ABC's additions to, or changes in, its Product mix. The design, engineering, fabrication, and installation of the conveyor required that the Seller create extensive blueprints outlining its layout of the newly configured cells and the most effective design to accommodate the various heights, lengths, and weight variances. The blueprints—through layout drawings, electrical drawings and pneumatic drawings—illustrate the conveyor's floor supports (including its angles and elevations), the placements of its different types of cells, the location of its sensors and controllable elements, and the conveyor's interface with ABC's Warehouse floor plan. The blueprints convey many precise details which allow the conveyor to conform to the Warehouse's specific configuration—namely, the shortened length of Cell Five in comparison to the other cells to accommodate the Warehouse's unique shape; the positioning of a bridge conveyor at an unusual height to allow for under-passing delivery vehicles' utilizing of entry doors on both sides of the Warehouse; and the positioning of the palletizing equipment and pallet conveyor in relation to the pallet storage locations. Exhibit B includes six of the blueprints drawn—

namely, ABC (Plain View), ABC (3D Drawing), ABC Rendering, ABC Electrical Layout, Stacker (Upper Assembly), and Stacker (Layout Assembly).

The design of the computer operating system required the creation of a detailed *Operations Manual* specially-written for ABC's conveyor. The *Operations Manual* illustrates tracking steps for the numerous photo-eyes, push buttons, pilot lights, and solenoid valves that populate the towers. The *Operations Manual* directs users to action steps pertaining to product inventory, pallet movement, and alarm maintenance. (Exhibit C, attached herein, includes select pages of the *Operations Manual.)*

The conveyor's structural design features demonstrate that it is not permanently affixed to the Warehouse. In other words, the conveyor rests upon leg supports. The conveyor structure consists of rack frames, which are comprised of vertical columns with horizontal bracing and vertical cross bracing. The columns are structural tube or roll-forming steel sections. The frames are bolted to ensure sound and consistent construction. The base plate and splice bars are fixtures welded to the bottom of the columns. Rack structure rigidity is assured by column-to-column bracing between front and back columns. These rack frames are braced to each other both on the aisle side of the structure and on the back side. The bottom of all rack frames are welded to suitably-sized base plates, which are anchored to the floor by anchor bolts capable of resisting the shear and tensile forces caused by horizontal and vertical loading on the racks. (See the attached Layout B, Stacker Layout Assembly.) Despite solid construction, the conveyors may be removed, nonetheless, with no damage to the underlying realty as long as the bolts are unfastened, and the anchors are pulled out. Indeed, ABC's approval of the aforementioned design features evidences its own intention that the conveyors not be considered part of the underlying realty.

It is possible, therefore, that the conveyor system could be dismantled and erected at another warehouse. Practically speaking, however, it would be prohibitively expensive to do so, since another set up would require the entire redesign and reengineering of the conveyor and another extensive series of testing simulations to ensure its most efficient usage with minimal product breakage. In other words, any potential buyer of the conveyor would need to have precisely the same order flow, warehouse layout, floor plan, production requirements, inventory mix, and a myriad of other identical business operations in order for ABC's conveyor to have any value for it. In fact, ABC's conveyor would not even be useful at any other beverage distributor warehouse in the Midwest, as ABC's required SKU quantity substantially surpasses that of any other neighboring beverage distributor. In sum, no other business would purchase ABC's conveyor, as it would simply be less expensive and more practical logistically to contract for its own specially-ordered conveyor.

The Seller has issued ABC an invoice for the conveyor, which listed the purchase price but did not show tax charged. According to ABC, the Seller's costs incurred for design and engineering services, fabrication labor, and installation represent a very significant percentage of the conveyor's purchase price to ABC. The Seller is considered a service provider, as its line of business focuses predominantly, if not exclusively, upon providing engineering and design services to its customers.

ISSUE

In the absence of tax listed on the Seller's invoice, how should ABC treat the conveyors for Illinois sales and use tax purposes?

STATEMENT

ABC is not under audit by the IDOR. To the best of our knowledge, the IDOR has not previously ruled on the same or a similar issue for ABC, nor has ABC submitted a petition on a similar issue and withdrawn it before a letter ruling was issued.

LAW

Illinois imposes a Service Use Tax (the SUT) at a rate of 6.25 percent for the privilege of using in the state tangible personal property acquired as an incident to the purchase of a service from a serviceman. *35 ILCS 110/3; 35 ILCS 110/3-10*. When a serviceman contracts to design, develop and produce special-order machinery or equipment, taxation imposed by the SUT is based on the serviceman's cost price of the tangible personal property transferred incident to the completion of the contract. *35 ILCS 110/3d(2)*. 'Cost price' means the consideration that the serviceman pays to its supplier for the tangible personal property that it transfers to its service customer. *35 ILCS 115/2; 86 Ill. Admin. Code Sec. 140.201(a).* The IDOR will presume that a serviceman is required or authorized to collect the SUT if he bills tax to the service customer. *86 Ill. Admin. Code Sec. 160.101(g).* However, if an invoice from a serviceman does not show the tax, the IDOR will presume that the serviceman is either registered, and has included the SUT in the selling price of the tangible personal property transferred, or is a de minimis serviceman incurring a Use Tax[1] liability, in which case there is no self-assessment obligation on the part of the purchaser. *Id.* This presumption will be overcome only where the IDOR has evidence that the serviceman and/or the service customer were aware that the proper tax due was the Service Use Tax and that no action was taken to remit the Service Use Tax by either party to the transaction. *Id.*

Pursuant to an IDOR regulation, special-order machinery is produced when (1) the purchaser employs the seller specifically for its engineering and design skills to produce a machine to meet the purchaser's particular and unique needs; (2) the machine has use or value only for the specific purpose for which it is produced, and (3) the machine has use or value only to the purchaser. The regulation adds that, in the case of special conveyors, the sale would receive SUT treatment even if a fairly substantial portion of the conveyor were made of standard parts or raw material (such as steel) which could be stocked for sale. *86 Ill. Admin. Code Sec. 130.2115(b) and (c).*

Illinois case law addressing conveyors also stipulates three criteria for identifying special-order property subject to treatment under the SUT Act: (1) The seller contributes substantially to the design of the product. (2) The property has use or value only to the purchaser. In other words, the property has to be produced according to special requirements peculiar to the purchaser and not common to others whose conditions for possible use of the property are reasonably comparable to those of the purchaser. (3) The equipment has only salvage value to others and therefore is useless to anyone but the customer for whom it is produced. *Caterpillar Tractor Co. v Department of Revenue (Illinois Supreme Court, 1963). Velten & Pulver, Inc.* v. *Department of Revenue (Illinois Supreme Court*, *1963).*

[1] Illinois imposes a Use Tax at the rate of 6.25 percent upon the privilege of using in the state tangible personal property purchased anywhere at retail. 35 ILCS 105/3 and 35 ILCS 105/3-10.

ANALYSIS

ABC's conveyor meets for the following reasons the requirements under Illinois law for designation as special-order property:

- ABC selected the Seller over other business competitors because of the Seller's industry specific experience and its commitment to designing and engineering conveyors to meet a customer's specific needs.

- The Seller's development of a design plan—including approximately 40 engineering blueprints and a specialized operations manual—and its performance of extensive testing and simulations demonstrate that it created a conveyor to fit the rigorously exact and unique specifications required by ABC at its particular Warehouse location.

- Emphasis on the Seller's design and engineering skills is underscored by the fact that a very significant percentage of the Seller's production costs were attributable to services—design, engineering, fabrication, and installation labor.

- The conveyor has value only to ABC. Even if the conveyor were dismantled and set up elsewhere, the costs so incurred would exceed those attached to purchasing a new conveyor. As such, the conveyor has little more than scrap value to any other potential purchaser.

- The conveyor remains tangible personal property after its installation. As it has been only bolted down to the underlying realty, it may be removed without damaging the Warehouse. Further, ABC's approval of the Seller's design plan evidences its intention to maintain the conveyor as tangible personal property upon its installation.

Thus, applying state law to the facts in the case, ABC's conveyor should be considered special-order machinery.

The invoice issued to ABC for the special-order machinery did not show tax. Thus, applying state law and IDOR regulations to the facts in this case, the Seller is presumed to have included SUT in the selling price of the tangible personal property transferred to ABC, or the Seller is a de minimis serviceperson incurring a Use Tax liability. As such, ABC should have no SUT self-assessment obligation.

CONTRARY AUTHORITY AND DISCUSSION

No contrary authority has been found.

INFORMATION TO BE WITHHELD

We respectfully request that the IDOR delete ABC's name from the publicly-disseminated version of the PLR.

CONCLUSION

Based on the foregoing analysis please confirm that:

- No obligation exists on the part of ABC to remit tax to the IDOR due to the presumption that the Seller either has included tax in the invoiced selling price of the conveyor or is a de minimis serviceperson incurring a Use Tax liability.

We also respectfully request that, if the IDOR disagrees with the conclusions indicated herein, that you contact me before rendering a written decision and issuing a PLR addressing the issues presented. Your care in responding to our requests is very much appreciated.

March 1, 2006 letter:

I am writing to provide you and the Department of Revenue with additional information to support our request for a Private Letter Ruling on behalf of ABC. On March 25, 2004 we requested a ruling from the Department to the effect that a conveyor system installed in its Illinois distribution center qualified as special order machinery and equipment under the provisions of 86 Ill. Admin Code, Sec. 130.2115.

We initially demonstrated that the conveyor system was specially designed, engineered and fabricated for ABC. The Department questioned whether the conveyor system qualified under the regulation and offered us an opportunity to present additional information to support the request.

ABC commissioned an appraisal of the system by XYZ. That appraisal report and all of its exhibits are enclosed.

The conveyor system initially cost ABC $1.6 Million when it was installed in 2003. It would cost approximately $2 Million if purchased today, largely due to an increase in the price of steel.

There are only 8 similar known conveyor systems currently installed in the United States. There are only 200 distributors that would have a use for a system like this one. Additionally, most of the installed systems are fully automatic while this one is semi-automated. There has been no sales of similar systems in the secondary market.

If the system were sold, the buyer would incur expenses for the acquisition price and additional expenses for de-installation, transportation, re-installation, software changes and upgrades and retrofitting. The additional expenses would be in the range of 45%-60% of the new cost of the conveyor system, or $900,000 to $1,200,000.

The appraiser found that the conveyor system would have a fair market value of $400,000, if a buyer could be found and if time were not a factor in arranging a sale. He also estimated that an immediate auction value for the system was $150,000. Thus, the potential estimated value range as a percentage of original purchase price is 9.39% to 25% and the potential estimate value range as a percentage of replacement price is 7.5% to 20%.

The Department's Regulation states that a specially produced item should have use or value (other than salvage value) only to the purchaser. There is no definition of the term salvage value in the Service Occupation Tax or in the Regulations. The Illinois case law has always found conveyors to be special order equipment. The [sic] have been two instances where the Illinois Supreme Court actually stated a valuation percentage in its opinions regarding special order property the first was Oscar L. Paris v. Lyons, 8 Ill. 2d 590, (1956) where the court

accepted the uncontradicted proof that the salvage value of special order carpet was 10-25%. The second was American Brake Shoe v. Department of Revenue, 25 Ill.2d 354 (1953) where the Court accepted a salvage value of 7.5%. In neither instance did the court find that the values before it exceeded the regulatory standard of salvage value.

With respect to printed material produced on special order the Department adopted a standard of considering whether the printed material could be sold for substantially the same price to someone other than the customer for whom the material was produced to determine if items were produced on special order. See 86 Ill. Admin. Code, Sec. 130.2000 (b) (2):

Clearly salvage value is not scrap value. In this case, the scrap value of the conveyor is substantial. The scrap value of the steel in the conveyor is about $166,250 based on an estimated weight of 475 tons at $350 per ton for scrap steel. In the past the Department and the Courts have determined that products produced on special order should be taxed under the Service Occupation Tax even if they had a salvage value in the range that the appraiser determined for this system.

Given the custom design of the system, that we established in our original request for a Private Letter Ruling, the extremely limited secondary market for this system, and its limited value in that market we submit the this [sic] system should be considered to be special order machinery and equipment.

If you have any questions or require any additional information, please call me.

DEPARTMENT'S RESPONSE

In order to make a finding that the purchase of an automated conveyor as described in this letter ruling request is not subject to Retailers' Occupation Tax because the seller of the conveyor is engaged primarily in a service occupation as described in 86 Ill. Adm. Code 130.2115(b), the Department must find that:

(1) ABC employed the seller primarily for his engineering or other scientific skill to design and produce the conveyor system on special order for ABC and to meet the particular needs of ABC;

(2) the conveyor system has use or value only for the specific purpose for which it is produced; and

(3) the conveyor system has use or value only to ABC.

While not ruling on whether ABC's conveyor system meets the first or second prong of the test, we do not believe it meets the third prong of the test. We are not convinced that ABC's conveyor system has use or value only to ABC. ABC purchased the conveyor system in 2003 for $1,600,000. The cost of that same system purchased new today is estimated at $2,000,000. The appraisal supplied indicates that the Market Value of the conveyor system is $400,000. That appraisal also indicates that "de-installation, transportation, re-installation, software upgrades and retrofitting" would be approximately 25-40% of the cost for a new conveyor system.[2] Using the $2,000,000 estimate for

[2] Although taxpayer's letter indicates that additional expenses are 45-60% of the new cost of the conveyor system, the appraisal submitted with the letter puts these additional expenses at 25-40% of new cost. We believe that the taxpayer's percentages include the $400,000 acquisition cost as well as the additional expenses.

a new conveyor system, it would cost $500,000 to $800,000 in addition to the cost of purchase to de-install, transport, re-install, upgrade the software, and retrofit the conveyor system to make it operative in another location. Even using the highest figures provided in the appraisal, for a maximum of $1,200,000 ($400,000 purchase price plus $800,000 de-installing, re-installing and other costs) a purchaser could acquire ABC's 3-year-old conveyor system, appraised as being in "very good condition," and have it installed and running. That is $800,000 less than a new system. On the low end of the estimate, a purchaser could acquire and install ABC's conveyor system for $900,000 ($400,000 purchase price plus $500,000 de-installing, re-installing and other costs), a full $1,100,000 less than a new system. These figures do not support ABC's argument that the conveyor system has use or value only to ABC. As a result, it is our conclusion that the sale of this system is subject to Retailers' Occupation Tax and Use Tax rather than Service Occupation Tax and Service Use Tax.

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules, or the factual representations recited in this ruling.

If you have further questions concerning this Private Letter ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.]

Sincerely,

Samuel J. Moore
Associate Counsel

SJM:msk